



OFFICES OF THE COUNTY EXECUTIVE

Isiah Leggett
County Executive

Timothy L. Firestine
Chief Administrative Officer

May 26, 2009

Members of the Montgomery County Council

I am pleased to present to you the Quarterly Report of the Montgomery County Employees' Retirement System ("ERS") for the quarter ended March 31, 2009. This quarterly report is designed to assist you in understanding the current status of the ERS. This report was prepared pursuant to the provisions of the Montgomery County Code.

History

The Employees' Retirement System was established in 1965 as a cost-sharing multiple-employer defined benefit pension plan providing benefits to the employees of Montgomery County and other agencies or political subdivisions who elect to participate. The System is closed to employees hired on or after October 1, 1994, except public safety bargaining unit employees and employees who elect to participate in the Guaranteed Retirement Income Plan (effective July 1, 2009). There were approximately 4,850 active members and 5,550 retirees participating in the ERS as of March 31, 2009.

Performance Results

The total return achieved by the ERS assets for the quarter was a gain of 3.49%, 251 basis points behind the 6.00% gain recorded by the policy benchmark. For the one year period ending March 31, 2009 the ERS' gross return (before fees) was a loss of 24.32%, 299 basis points ahead of the 27.31% loss recorded by the policy benchmark. The one-year return places the ERS' performance at the median of a universe of public pension funds constructed by the Board's consultant, Wilshire Associates. For the three-year period, our annualized performance was a loss of 4.63%, before fees, ranking in the top third of the universe. The asset allocation at March 31, 2009 was: Domestic Equities 27.6%, International Equities 16.6%, Fixed Income 30.0%, Inflation Linked Bonds 11.4%, Commodities 2.4%, Private Equity 7.3%, Real Estate 4.3% and Cash 0.4%. We estimate that the funded status of the ERS was 78.6% as of March 31, 2009, a decrease from 78.7% at December 31, 2008. The actual funded status will be affected by the ERS' membership experience, as well as demographic and economic changes and may be higher or lower when calculated by the actuary during the next valuation.

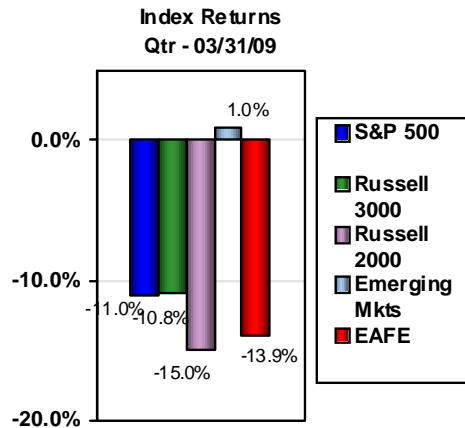
Major Initiatives

During the quarter, the Board approved an investment of \$8,000,000 in the Odyssey Investment Partners Fund IV and authorized staff to begin a search for a large cap growth manager. The Board also approved a change in the benchmark and investment guidelines for the private real assets sector. In addition, the ERS estimated FY09 and requested FY10 budgets were approved. The Board's consultant identified a company held by an ERS separate account manager that is doing business in Sudan and does not meet any of the exemptions stated in the County's Sudan Divestment legislation. The manager was advised that the requirements of the County Code require divestment within the next twelve months. The company will be placed on the restricted list for future investment by all ERS separate account managers.

Capital Markets and Economic Conditions

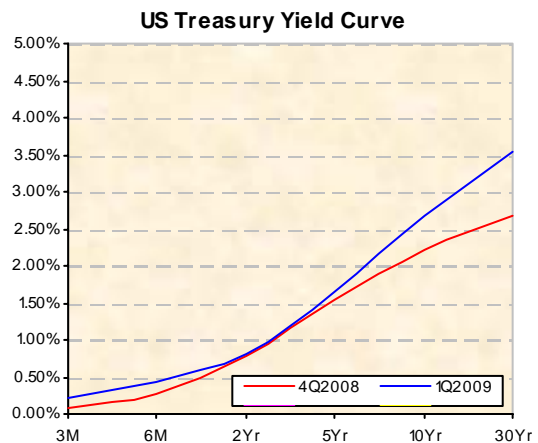
Global stock markets fell for the sixth consecutive quarter amid news of continued economic weakness. By the end of the first quarter, consumer confidence was near all-time lows and unemployment had risen to 8.5%. Fears of deflation emerged as the Consumer Price Index recorded a negative year-over-year change for the first time since 1955. Governments worldwide instituted monetary and fiscal stimulus programs to fight the recession, though capital markets have responded to these programs with varying degrees of success.

Public Equity Markets: The performance during the first quarter of the U.S. stock market resembled last year's fourth quarter with both periods experiencing a significant decline in the first two months of the quarter followed by a powerful rally during the last month. The rally, which began on March 9th and continued through the beginning of April, was driven by investor hopes that the recession would end during the 4th quarter. As shown in the chart to the left, large capitalization companies (as represented by the S&P 500 Index) outperformed their smaller counterparts (Russell 2000 Index) for the quarter. Growth stocks continued to outperform value stocks across the capitalization spectrum. All sectors of the S&P 500, except IT, were in negative territory during the quarter, with financials and industrials performing the worst. Our combined domestic equity performance was a loss of 9.16%, 164 basis points ahead of the Russell 3000 benchmark. For the one year period ending March 31, our combined domestic equity portfolio recorded a loss of 36.94%, 126 basis points better than the 38.20% loss recorded by the benchmark.



Within the international equity sector, developed markets, as measured by the MSCI EAFE Index, were down 13.94% for the quarter, compared to emerging markets which advanced 0.95%. All EAFE markets, except Norway, were down with Finland (-22.21%) and Italy (-20.58%) detracting the most from returns. The markets of Chile (13.55%) and Brazil (12.45%) took the lead within the emerging markets sector. Our combined international equity performance was a loss of 9.18% (9.50% after including the negative performance of our currency managers) for the quarter, 153 basis points ahead of the benchmark's loss of 10.71%. For the one year period ending March 31, our combined international equity return was a loss of 41.40% (40.92% after including the currency managers), outperforming the benchmark by 506 basis points.

Fixed Income: Despite the Federal Reserve's quantitative easing measures to keep interest rates low, Treasury yields rose on concerns that the US Government will need to increase the supply of bonds to fund the additional stimulus packages. The yield curve also steepened as the 2 year Treasury bond rose 3 bps from 0.77% to 0.80% and the 30 year Treasury bond rose 86 bps from 2.68% to 3.54%. The investment grade credit sector underperformed with finance and insurance industries faring the worst. The Barclays Corporate Index fell 1.78% while the Barclays Treasury Index declined 1.32%. CMBS and ABS rebounded in March after the government announced their inclusion in the expanded version of the Term Asset-Backed Securities Loan Facility (TALF). The high yield bond market, represented by the Merrill Lynch High Yield Master II Index, continued to rally, up 5.51%. Long credit issues suffered three consecutive down months as credit spreads widened. Our combined fixed income performance for the quarter was a gain of 0.50%, underperforming the 1.07% gain recorded by the benchmark index. Our global inflation-linked bond portfolio, combined with the portable alpha overlay, returned 2.34% for the quarter, compared to the 2.42% return of the benchmark.

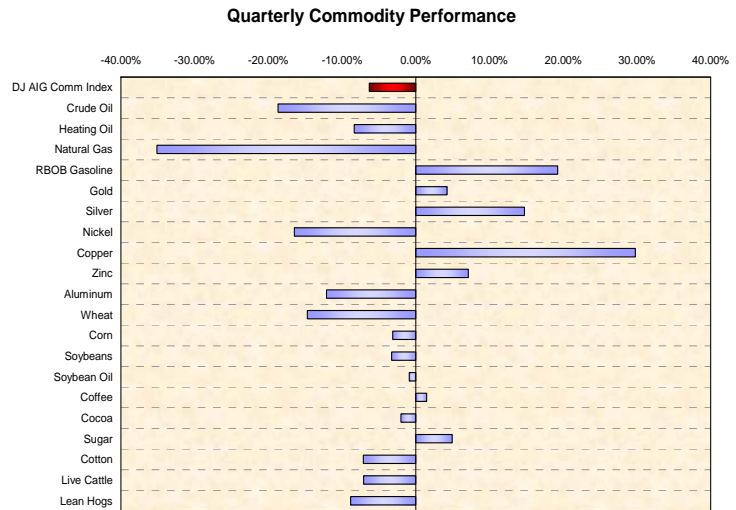


Private Equity: First quarter private equity investment and fundraising activity was slow due to diminished availability of debt and uncertainty over the financial system. Private equity fund valuations, which are reported on a quarter lag, have shown a large drop at year-end reflecting the deteriorating economy and public market comparables. During the first quarter, our private equity managers called a combined \$4.2 million and paid zero distributions. Our current allocation to private equity is 7.3%, with a market value of \$139.9 million.

QUARTERLY REPORT

Real Estate: Real estate investment activity continued its slow pace, as lack of debt financing, mismatches between buyer and seller expectations, and economic conditions caused investors to pause. Economic conditions are causing companies to reduce their demand for commercial real estate space; this has affected both occupancies and rental rates, though the degree to which these are affected can vary widely by locality. During the quarter, our real estate managers called a total of \$1.8 million and paid distributions of \$0.2 million. Our current allocation to real estate is 4.3%, with a market value of \$82.3 million.

Commodities: The severe correction to commodity futures prices that began in the second half of 2008, continued well into the first quarter of 2009. The Energy sector suffered the greatest damage, receding more than 18%, led by the fall (-35%) of Natural gas prices due to the increase in supply and decrease in industrial demand. Copper was the best performing subsector (+30%) driven by demand from China. Precious metals advanced as they are traditionally solid performers during periods of high economic risk and afford investors a hedge against both financial market implosion and the possibility of price inflation. During the quarter, our commodities portfolio declined 5.88%, outperforming the DJ AIG Commodities Index by 43 bpts.



Additions

The primary sources of additions for the ERS include member and employer contributions and investment income. The following tables show the source and amount of additions for the quarter ending March 31, 2009 and fiscal year-to-date.

Employees' Retirement System

Contributions and Investment Income (millions)

	Qtr 3/31/2009	Fiscal YTD
Employer Contributions	\$ 26.1	\$ 81.5
Member Contributions	4.2	13.5
Net Investment Income (Loss)	(108.2)	(639.0)
	<u>\$ (77.9)</u>	<u>\$ (544.0)</u>

Deductions

The deductions from the Employees' Retirement System include the payment of retiree and survivor benefits, participant refunds, and administrative expenses.

Employees' Retirement System

Deductions by Type (millions)

	Qtr 3/31/2009	Fiscal YTD
Benefits	\$ 41.6	\$ 128.1
Refunds	-	0.4
Administrative Expenses	0.9	1.9
	<u>\$ 42.5</u>	<u>\$ 130.4</u>

Outlook

The banking industry and consumers are two critical determinants of the speed and magnitude of an economic recovery. While banks recently gained a measure of accounting relief from marking their assets to market, higher credit-related losses still point to a weak economic reality. For banks to extend additional credit, they must first be comfortable with their existing assets and then with the creditworthiness of new borrowers. The market itself cannot give them this comfort, so the government is attempting to do this through numerous programs. In doing so, the government must walk a fine line between ensuring adequate monitoring of public funds used for these programs and allowing banks to operate freely without being stifled. At present, capital markets are very sensitive to any new announcements regarding these programs.

Consumers comprise over 70% of U.S. GDP, and as they are affected by job losses, falling asset values and uncertainty over their economic futures, evidence shows that they have tightened their spending. Investors are grappling with whether this is a temporary adjustment that will reverse when signs emerge that the economy is changing course or a more permanent change that will affect a generation of consumers. In the meantime, government spending can make up a portion of spending formerly undertaken by consumers. However, this is not sustainable over the long-term.

**EMPLOYEES' RETIREMENT SYSTEM
STATEMENTS OF PLAN NET ASSETS**
March 31, 2009

Assets

Equity in pooled cash and investments	\$ 447,520
Investments:	
Northern Trust	2,054,220,559
Aetna	13,812,486
Fidelity - Elected Officials Plan	585,978
Fidelity - DRSP	637,957
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Total investments	2,069,256,980
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Contributions receivable	4,976,324
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Total assets	2,074,680,824
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Liabilities

Benefits payable and other liabilities	130,197,930
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Net assets held in trust for pension benefits	\$ 1,944,482,894
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**EMPLOYEES' RETIREMENT SYSTEM
STATEMENTS OF CHANGES IN PLAN NET ASSETS**

March 31, 2009

	Quarter	Fiscal YTD
Additions		
Contributions:		
Employer	\$ 26,060,809	\$ 81,526,648
Member	<u>4,214,004</u>	<u>13,528,599</u>
Total contributions	<u>30,274,813</u>	<u>95,055,247</u>
Investment income (loss)	(105,179,155)	(629,461,991)
Less investment expenses	<u>3,000,085</u>	<u>9,545,136</u>
Net investment income (loss)	<u>(108,179,240)</u>	<u>(639,007,127)</u>
Total additions (deletions)	<u>(77,904,427)</u>	<u>(543,951,880)</u>
Deductions		
Retiree benefits	30,427,789	94,200,674
Disability benefits	9,326,105	28,369,494
Survivor benefits	1,827,092	5,469,236
Refunds	20,307	376,818
Administrative expenses	<u>859,686</u>	<u>1,950,443</u>
Total deductions	<u>42,460,979</u>	<u>130,366,665</u>
Net increase (decrease)	<u>(120,365,406)</u>	<u>(674,318,545)</u>
Net asset held in trust for pension benefits		
Beginning of period	<u>2,064,848,300</u>	<u>2,618,801,439</u>
End of period	<u>\$ 1,944,482,894</u>	<u>\$ 1,944,482,894</u>